DRAFT

STATE BOARD OF EQUALIZATION
STAFF LEGISLATIVE BILL ANALYSIS

Date Introduced:	**02/17/05**	Bill No:	**AB 735**
Tax:	**Sales and Use**	Author:	**Arambula**
Related Bills:	**AB 168 (Ridley-Thomas)**		

BILL SUMMARY

This bill would do the following:

- Require the Legislative Analyst's Office (LAO) to establish a process to review all tax exceptions, and submit a report to the Legislature by December 31, 2006.
- Require the LAO, by December 31 of each even-numbered year, to submit a report to the Legislature providing a thorough analysis of tax exceptions.
- Require the LAO to review and analyze any relevant reports prepared by the Department of Finance (DOF), and request assistance from the Board and the Franchise Tax Board (FTB) in order to make the report as comprehensive as possible.
- Direct the Assembly and Senate Revenue and Taxation Committees to review the report submitted by the LAO and authorize them to select a group of tax exceptions for deletion or modification, reporting their recommendations to the fiscal committees for consideration during the budget process.

ANALYSIS

Current Law

Since 1971, pursuant to Section 13305 of the Government Code, the DOF has been required to provide a tax expenditure report to the Legislature. Chapter 1762, Statutes of 1971, required that the report be submitted to the Legislature once every two years. Chapter 268, Statutes of 1984, increased the reporting frequency to once a year. The required report includes each of the following:

- A comprehensive list of tax expenditures.
- Additional detail on individual categories of tax expenditures.
- Historical information on the enactment and repeal of tax expenditures.

Proposed Law

This bill would add Section 9145 to the Government Code to require the LAO to establish a process to review all tax exceptions, as defined, and to submit a report to the Legislature on the tax exception review process on or before December 31, 2006. The review must include the following:

- A fiscal and economic analysis that considers the original social and economic purpose of the tax exception.
- A discussion and examination of the minimal level necessary for each tax exception to achieve the state's objective.
- An evaluation of income groups that benefit by the tax exception, the distribution of benefits among income groups, and the effect of the exception on the overall distribution of the tax burden.
- A discussion of the extent to which any federal tax exceptions may overlap.

This bill defines "tax exceptions" to mean the various tax exclusions, exemptions, credits, deferrals, and preferential tax rates that reduce the amount of revenue collected from the state's basic tax structure.

If any of the information required to be included in the review process is not available, the LAO would be required to include a reason why the information is missing and what is needed to make it available.

The LAO would be required to review and analyze any relevant reports prepared by the DOF and **request assistance from the Board and the FTB to make the report on tax exceptions as comprehensive as possible.**

On or before December 31 of each even-numbered year, the LAO would be required to submit a report to the Legislature providing a thorough analysis of tax exceptions. The report would discuss the identified tax exceptions to which any of the following applies:

- The exception provides windfall benefits to individuals or groups whose behavior is unaffected by the tax incentive.
- The exception works contrary to the objectives of other state programs or other tax exceptions.
- The exception is no longer consistent with the original goals and objectives for which it was intended.
- The exception has little or no clear economic or social justification.
- The exception benefits primarily only a clearly identifiable single economic entity or very small special interest group.

The report would also be required to contain an estimate of the rate of growth of the total amount of tax exceptions over the previous year and identify those tax exceptions that are growing at rates in excess of the growth rate of the General Fund budget.

This bill would require the Committee on Revenue and Taxation of each house to review the report and would authorize them to select a group of tax exceptions for special review. The committees could recommend tax exceptions from that group for deletion or modification and provide their recommendations to the fiscal committees for consideration during the budget process. The resulting bill would be referred to as the "Tax Exception Budget Revision Bill."

Background

AB 2106 (Ridley-Thomas, 2004) was introduced as a result of Assembly Budget Committee Oversight hearings at which was discussed the usefulness of regular ongoing review and evaluation of tax expenditures as a means to eliminate wasteful or ineffective programs. This bill would have required the DOF, in conjunction with the Governor's Budget, to submit to the Legislature a report of tax expenditures currently in effect. The bill would have also specified that, among other things, based on information provided by the Board and to the extent feasible, the report include the number of tax returns or taxpayers affected by any sales or use tax expenditure, the distribution of that expenditure, and the size any type of business or industry to which that expenditure is made available.

AB 2106 was vetoed by Governor Schwarzenegger. The Governor's veto message states:

> "Under existing law, the Department of Finance already is required to provide an annual tax expenditure report to the Legislature containing specific information. This bill changes the type of information that is provided in the annual report. However, some of the information that Department of Finance would be required to report is not available. For example, the original intent of a given tax expenditure is often not clearly defined in the enabling statute. In addition, the number and income distribution of taxpayers benefiting from sales tax exemptions would not be known because this information is not required to be reported by retailers when filing their tax returns. Furthermore, some of the information might not be available for reporting to the Legislature because of existing confidentiality requirements."

SB 1710 (Hayden, 2000) would have enacted the 2000 Public Subsidies, Public Benefits Act and would have required the LAO to complete reviews of the economic and employment impacts of selected state business tax expenditures, as defined, and selected public subsidies by the state that would be selected annually in consultation with the chairs of the finance committees of the Legislature. This bill would have required the Board to report to the LAO specified information regarding taxpayers claiming any business tax expenditure or receiving any public subsidy. The bill also would have imposed specified reporting requirements on taxpayers claiming any business tax expenditures or receiving a public subsidy and would have required that such reports be made to the FTB and other agencies providing a public subsidy.

SB 1710 was vetoed by Governor Davis. Governor Davis' veto message stated, in part:

> "Implementing this bill would result in significant administrative costs for the Franchise Tax Board to develop new procedures to collect and verify information that is not part of the existing tax system."

COMMENTS

1. **Sponsor and purpose.** This bill is sponsored by the author for the purposes of establishing a reporting system in order to evaluate the effectiveness of tax exceptions.

2. **The Board does not have specific data on all tax expenditures.** In general, revenue estimates and expenditure data for the Personal Income Tax and Corporation Tax Laws are easier to quantify than they are for the Sales and Use Tax Law. Personal income and corporation tax returns contain significant detail regarding different sources of income and types of exemptions, exclusions, deductions, and credits claimed. Thus, tax return data are often available when estimating the fiscal impact of various income and corporate tax expenditure programs. In contrast, returns filed by taxpayers under the Sales and Use Tax Law (a copy of which is attached) contain little specific information regarding tax expenditures.

   As shown on the attached sales and use tax return, some of the more common tax expenditures allowed under the Sales and Use Tax Law are separately identified on the return itself for purposes of allowing taxpayers to claim the deduction. These include deductions for, among others, sales of food products, sales to the U.S. Government, sales in interstate or foreign commerce, and nontaxable labor (note, the law contains numerous other tax exemptions and exclusions not separately identified on the return). However, instead of actually itemizing these deductions, many taxpayers simply report their taxable sales, netting out any exempt sales. Any attempt to capture the amount of exempt sales would require a much more extensive tax return and would require a very large effort from taxpayers to detail these transactions. However, even if the Board were to require retailers to report on each tax expenditure, we would still not have any data regarding the consumers that are actually benefiting from these exemptions.

   Because the sales and use tax return information does not capture specific data on the myriad of tax exemptions and exclusions provided under the law, it is not a reliable source to use in making estimates of revenue losses attributable to those exemptions and exclusions. Consequently, the Board generally relies on independent data sources when estimating the revenue impacts of various sales tax expenditure programs.

   The exception to this is for partial exemptions. The Board currently requires the taxpayer to specify the amount of those exemptions that apply to only a portion of the combined state and local sales and use tax. There are currently five such exemptions in effect:

   Teleproduction Equipment

   Farm Equipment

   Diesel Fuel Used in Farming and Food Processing

   Timber Harvesting Equipment and Machinery

   Racehorse Breeding Stock

   Sales of these commodities are exempt from the *state* sales and use tax. Local and special district sales and use taxes continue to apply. In order for a taxpayer to claim these exemptions, they must report the amount of the transactions that are subject to the partial exemption.

   Since the bill provides that the LAO shall request assistance from the Board in order to make the report as comprehensive as possible, it is assumed that the Board would provide the LAO with the information that it is currently capturing.

3. **The Board's Publication 61, *Sales and Use Taxes: Exemptions and Exclusions*, provides a detailed listing of various exemptions and exclusions from the sales and use tax.** Publication 61 summarizes the various sales and use tax exemptions and exclusions. The publication has two sections: first by category and second by alphabetical reference. The listings provide a brief general description of the exemption or exclusion, including the statutory authority. The listing by category also provides an estimate of the revenue loss of the exemption or exclusion, if available. As previously stated (see Comment 2), a revenue loss of a particular tax expenditure is not always possible to quantify.

4. **Related Legislation.** AB 168 (Ridley-Thomas) would, among other things, do the following: (1) require the Board and the FTB to each provide a report of the estimated revenue losses of tax expenditures, determined using a static revenue analysis, in excess of $10 million, no later than November 15, 2006, and on or before November 15 of each year thereafter; (2) require the DOF to provide a report to the Legislature and the LAO of the estimated revenue losses attributable to the tax expenditures identified in the Board's and the FTB's reports, by February 1, 2007, and on or before January 15 of each year thereafter; and (3) require the LAO to review the reports submitted by the Board, FTB, and DOF and make recommendations to the Legislature regarding tax expenditures to modify or repeal, by March 1, 2007, and on or before March 1 of each year thereafter.

COST ESTIMATE

As explained previously, the Board does not capture reliable data on tax expenditures from tax returns or from taxpayers, other than that obtained on the five partial tax exemptions. This bill requires the LAO to prepare a report, on or before December 31 of each even-numbered year, providing a thorough analysis of tax exceptions. The bill also states that the LAO can request assistance from the Board and the FTB in order to make the report as comprehensive as possible. It is assumed that the Board would provide the LAO information that we currently obtain from returns. Based on that assumption, any costs associated with this bill would be insignificant.

REVENUE ESTIMATE

To the extent that future reviews and evaluations result in the identification and termination of ineffective or inappropriate tax expenditures, enactment of this measure could result in unknown additional revenues.

ATTACHMENT

http://www.boe.ca.gov/pdf/boe401a2.pdf

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